

for two-earner married couples; larger tax-deductible contributions to special savings accounts; and more rapid cost recovery of expenditures for equipment and structures.

The significance of the act is reflected in the estimated reductions in revenue, which grow from \$39 billion in fiscal year 1982 to \$294 billion in 1987, as shown in Table 11. In 1987, the percentage reduction in revenues reaches 25 percent. As percentages of GNP, these reductions grow from 1.2 percent in 1982 to 5.9 percent in 1987. In contrast, the revenue reduction from the Revenue Act of 1964 (Public Law 88-272) is estimated to have grown to only 2.0 percent of GNP by the seventh year after passage.

TABLE 11. REVENUE EFFECTS OF ECONOMIC RECOVERY TAX ACT  
(By fiscal year, in billions of dollars)

	1981	1982	1983	1984	1985	1986	1987
Individual Income Taxes							
Rate cuts	--	-25	-65	-102	-116	-130	-147
Indexing	--	--	--	--	-12	-30	-51
ACRS <u>a/</u>	*	-2	-3	-4	-6	-8	-10
Other	*	-1	-6	-11	-13	-18	-22
Corporate Income Taxes							
ACRS <u>a/</u>	-1	-10	-16	-23	-33	-44	-50
Other	--	-1	-1	-2	-3	-4	-4
Excise Taxes	--	-2	-1	-1	-2	-3	-3
Estate and Gift Taxes	--	*	-2	-4	-5	-6	-7
Total	-2	-39	-95	-148	-189	-244	-294

\*Less than \$500 million.

a/ Accelerated Cost Recovery System.

#### Provisions Affecting Individuals

The principal provisions affecting individual taxpayers are across-the-board income tax rate reductions and the subsequent indexing of the bracket structure, the tax deduction for two-earner married couples, and a

number of savings incentives. The latter include expanded individual retirement accounts (IRAs) and self-employed retirement accounts (Keogh plans), All Savers certificates, and the 15 percent net interest income exclusion.

The act reduces individual income tax rates by (cumulatively) 1.25 percent in 1981, 10 percent in 1982, 19 percent in 1983, and 23 percent in 1984. Withholding rates were reduced by 5 percent on October 1, 1981, and will be reduced by an additional 10 percent on July 1, 1982, and another 10 percent on July 1, 1983. The top marginal rate was reduced from 70 percent to 50 percent on January 1, 1982, ending the tax distinction between earned and unearned income. The maximum rate on long-term capital gains was reduced to 20 percent for sales or exchanges completed after June 9, 1981.

The across-the-board rate cuts are the major component of the reduction in personal taxes provided by the act--accounting for 85 percent of the total decrease in income and estate and gift taxes during the 1982-1984 period. Revenue reduction from the across-the-board rate cuts grows from \$25 billion in 1982 to \$102 billion in 1984, when the reductions are fully phased in. At 1983 income levels, a 10 percent cut in tax rates decreases tax liability by about \$35 billion.

The act provides for automatic annual adjustments in the individual income tax brackets, the zero bracket amount, and the personal exemptions beginning on January 1, 1985. These adjustments will be based on the rate of inflation, as measured by the Consumer Price Index, experienced during the fiscal year ending three months before the start of each tax year. By 1987, the revenue reduction from indexing grows to \$51 billion--second in importance to the across-the-board rate cuts.

The act provides a new deduction for two-earner married couples filing joint returns and increases the maximum possible deduction for contributions to IRAs, expanding the eligibility for this deduction to active participants in employer-sponsored retirement plans. The act also doubles the maximum annual deduction for contributions to qualified Keogh plans.

Another significant savings incentive is scheduled to go into effect in 1985. Beginning in that year, individuals will be allowed an exclusion of 15 percent of net interest received, up to \$3,000 of net interest (\$6,000 on a joint return). This provides a maximum exclusion of \$450 for each individual. Other provisions include an increase in the child-care credit and a reduction in the top estate and gift tax rate from 70 percent to 50 percent.

## Business Provisions

The Tax Act provides substantial reductions in the tax burden on income from capital investments by significantly accelerating depreciation deductions for most property placed in service after December 31, 1980. The new depreciation system is called the Accelerated Cost Recovery System (ACRS).

Depreciable property is now allocated to one of four classes with recovery periods of 3, 5, 10, and 15 years. Accelerated methods of scheduling annual cost recovery deductions over the tax life of the property are allowed, with an even more accelerated method permissible after a five-year phase-in period. A 6 percent investment tax credit is provided for three-year equipment, while the 10 percent credit is retained for other eligible equipment.

Other business provisions of the act include increased investment credits for expenditures to rehabilitate older nonresidential structures and a temporary tax credit for certain increased research and development expenditures. The tax rates on the first \$50,000 of corporate taxable income and the windfall profit tax rate on newly discovered oil are reduced in several annual steps, beginning in 1982.

ACRS is the major element of the reduction in corporate income taxes--providing over 90 percent of the total decrease in corporate taxes during 1982-1987. This corporate income tax reduction accounts for only about 80 percent of the total revenue cut resulting from ACRS. The remaining 20 percent accrues to noncorporate businesses and reduces individual income taxes.

The magnitude of the corporate tax reduction resulting from ACRS is quite substantial. In 1987, the corporate income tax cut resulting from ACRS equals \$50 billion, and is roughly equivalent to that which would result from a decrease in the top corporate rate from the present 46 percent to 30 percent.

While the business tax reductions provided by the Tax Act will significantly lower tax rates on corporate profits and considerably restrict the future growth in corporate tax revenues, they will not eliminate the corporate income tax. That would require annual depreciation deductions significantly in excess of total annual corporate fixed investment. The maximum addition to normal depreciation deductions expected during the projection period as a result of ACRS amounts to less than one-third the addition needed to offset taxable income fully. Corporate income tax receipts, therefore, do not fall below \$50 billion in any year during the projection period.

Many companies do not have sufficient taxable income to take advantage of the increased deductions and credits made available under ACRS. As a means of increasing the incentives to invest, the act establishes so-called "safe harbor" leases that allow a user of newly purchased equipment (the lessee) to transfer the tax benefits to a corporate investor (the lessor). The result of this provision is the full transferability of these tax benefits to companies that are able to take advantage of them. In the light of data available on the volume of leasing activity to date, it appears reasonable to estimate the revenue loss attributable to the new safe harbor leasing provisions at less than 20 percent of the total revenue loss from ACRS.

### IMPLICATIONS OF THE TAX ACT

All taxes affect economic decisions in one way or another. Some level of taxation, however, is necessary if governmental functions are to be carried on. The way a tax system distributes the tax burden among different taxpayers, individual or corporate, and among different types of economic activity, determines its effect on productivity and economic growth. Very high tax burdens and large divergences in the marginal tax rates facing different taxpayers can impede productivity growth. The effects of the Tax Act on relative tax burdens, and its potential impact on saving and investment incentives, are discussed briefly below.

#### Tax Burden

As mentioned above, although total revenues increase at a 6.9 percent annual rate over the projection period, they decline steadily as a share of GNP--from 20.6 percent in 1982 to 17.7 percent in 1987. This is a reversal of the pattern of steady increases in the revenue share of GNP experienced since 1976. Those increases in GNP share reflected for the most part the continuation of a history of legislated increases in social insurance taxes and the effect on income taxes of bracket creep--the growing share of incomes claimed by the progressive individual income tax during an inflationary period.

The corporate income tax, on the other hand, has dropped steadily as a share of GNP since the early 1950s. The 1952-1976 reduction in the corporate tax share was partly the result of legislated changes--in particular, the institution of and subsequent increase in the investment tax credit and the acceleration of cost recovery deductions for investment expenditures.

Excise taxes have also claimed a decreasing share of GNP over this extended period, caused partly by the removal of some excises and partly by the closer relationship of excise revenues to the volume of transactions rather than to the more rapidly increasing dollar value of these transactions. This pattern was reversed in 1980, when the windfall profit tax was put into place.

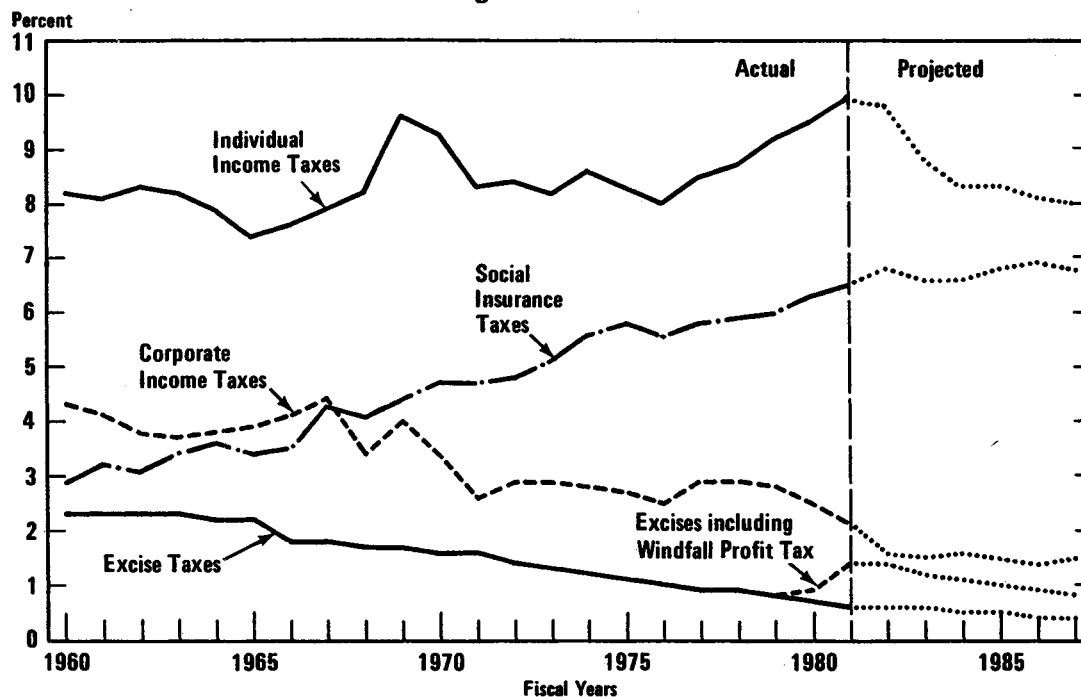
Over the 1982 to 1987 period, with the Economic Recovery Tax Act in effect, the share of GNP claimed by each major type of tax decreases from its 1982 level, with the exception of the share claimed by social insurance taxes, which remains roughly constant over the period. Social Security taxes make up about 85 percent of social insurance taxes. Beginning in 1982, the maximum taxable wage level (base) for Social Security will be indexed, in order to keep roughly constant the percentage of earnings in covered employment that are subject to the tax. The combined employer and employee tax rate for Social Security increased at 0.1 percent at the beginning of 1982, and will increase by 0.7 percent in 1985 and by 0.2 percent in 1986. The revenue increases attributable to the combined increases in the base and the rate grow from \$2 billion in 1982 to \$48 billion in 1987.

The windfall profit tax share of GNP falls over the 1982-1987 period, as windfall tax revenues actually decrease slightly each year. The drop in windfall revenues reflects decreases in the average windfall tax rate as oil production shifts from higher-taxed tiers to lower-taxed tiers, and decreases in the margin between the selling price and the indexed base price on which the tax is levied. Oil prices are projected to decline somewhat in 1982 and then to increase sufficiently to remain roughly constant in real terms over the projection period. The trends since 1960 in the GNP shares of the major types of taxes are shown in Figure 4.

Projected changes in the relative contributions of different taxes to total revenues provide another measure of the effects of the Economic Recovery Tax Act. The contributions of both individual and corporate income taxes decline steadily over the projection period. The corporate share decreases from 10.1 percent of total revenues in 1981 to 8.3 percent in 1987--a new low. The individual income tax contribution decreases from 47.4 percent in 1981 to 44.9 percent in 1987.

Social Security taxes increase steadily in importance as a revenue source during the period. Total social insurance taxes grow from 30.9 percent of revenues in 1981 to 38.4 percent in 1987. This relative increase in the importance of wage taxes relative to income taxes tends to make the personal tax system less progressive.

Figure 4.  
Revenue Sources as Percentages of GNP



Aggregate personal tax burden, measured by the sum of income taxes plus social insurance taxes as a percent of taxable personal income, decreases from 23.8 percent in 1982 to 22.2 percent in 1987.<sup>1/</sup> The increase over the period in the amount of income claimed by social insurance taxes is more than offset by the decrease in the amount claimed by income taxes.

#### Bracket Creep and Changes in Effective Tax Rates

The Tax Act substantially reduces average personal income tax rates over the 1981-1984 period through cumulative across-the-board rate reductions. These changes work to counteract the effects of the inflation-

<sup>1/</sup> Taxable personal income is the sum of four income measures of the National Income and Product Accounts: wages and salaries, proprietors' income, personal rental income, dividends, and personal interest income. Capital gains are not included in this measure.

induced bracket creep inherent in the progressive income tax system. Bracket creep can lead to increased marginal and average tax rates for some taxpayers as increases in their incomes move them into higher tax brackets (even though their real purchasing power on a before-tax basis has not increased).

Even with moderating inflation, there will continue to be some bracket creep in the 1982-1984 period. For example, a typical married couple with one earner, filing a joint return, with \$35,000 in adjusted gross income in 1980, was in the 32 percent marginal tax bracket for that year. If this family's income were to increase by the same percentage as does the Consumer Price Index in the baseline economic assumptions, its income would equal \$47,390 in 1984 and it would be in the 33 percent marginal tax bracket. While the average tax rate has been reduced for these taxpayers, the marginal tax rate they face has not.

Bracket creep is strongest for the bulk of taxpayers in the lower- and middle-income range who populate narrower tax brackets than those at the upper end of the income range. The higher the rate of inflation, the greater the bracket creep experienced by the lower- and middle-income taxpayers.

Table 12 compares the revenue reductions resulting from the 1981 Tax Act with those that would have resulted from offsetting the effects of inflation under prior tax law. By 1984, these revenue effects are roughly equal to the inflation offset calculated from 1979--the year when income tax rates last changed. They are greater, however, than the inflation offset calculated from the time the first individual tax rate reductions in the Tax Act became effective.

Figure 5 shows effective income tax rates since 1960. For the period 1982-1987, it compares effective tax rates under the 1981 Tax Act, under prior law, and under prior law adjusted for inflation beginning on October 1, 1981.

### Investment Responses to the Tax Act

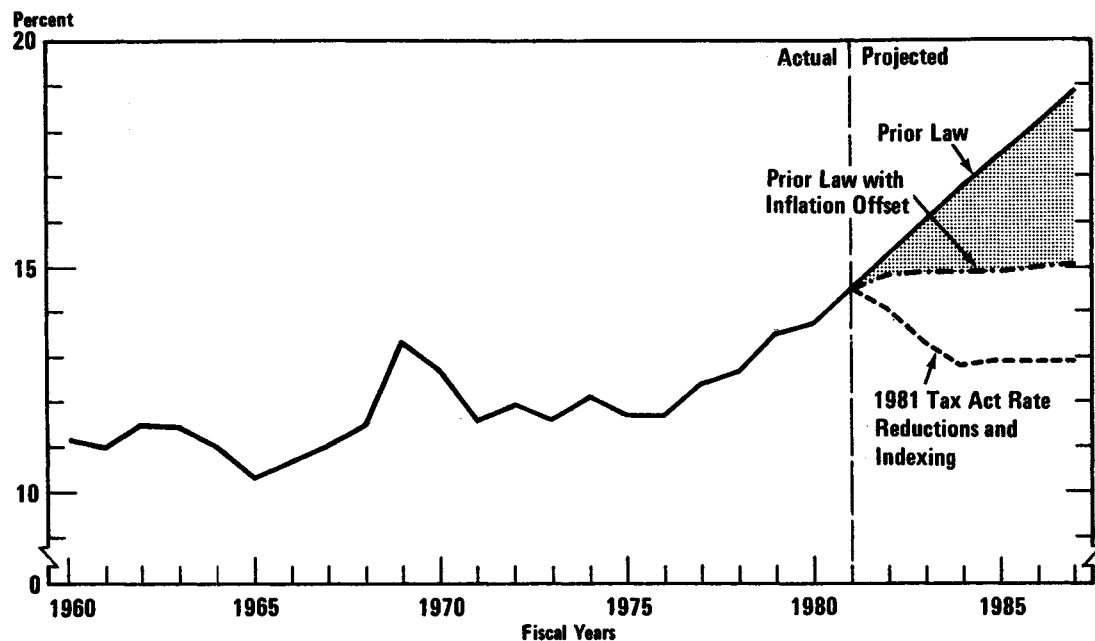
The Tax Act significantly reduces the tax burden on income from depreciable investments. Both the acceleration of depreciation deductions and, for some equipment, an increase in the investment tax credit will increase the after-tax rate of return on investment. This increased return, other things remaining the same, will tend to increase the level of investment above what it otherwise would have been.

TABLE 12. REVENUE REDUCTIONS UNDER THE 1981 TAX ACT  
COMPARED WITH INFLATION OFFSETS (By fiscal year, in  
billions of dollars)

	1982	1983	1984
Revenue Effects of the Rate Reduction Provisions of the Economic Recovery Tax Act of 1981	-25	-65	-102
Inflation Offsets a/ From October 1, 1981	-11	-26	-48
From October 1, 1979	-52	-72	-102

a/ Inflation offsets are estimated by calculating the difference between the income tax revenues that would have been collected in the absence of the 1981 Tax Act and those that would have been collected if individual income tax brackets, the zero bracket amount, and personal exemptions were adjusted for inflation.

Figure 5.  
Individual Income Taxes as a Percentage of Taxable Personal Income





ACRS does not, however, narrow the disparities between different types of depreciable business investments. This unevenness in tax treatment for different types of investments may lead to inefficiency in the allocation of capital.

Safe harbor leases provide a means of reducing some other potential distortions of the cost recovery system. Without safe harbor leasing, or a suitable alternative, the value of increased deductions and credits would vary with the present profitability of the user of the newly purchased equipment. This variance would lead to the misallocation of capital resources and would generate pressure for corporate mergers. These distortions would reduce the efficiency of the intended investment stimulus.

#### CHANGES IN PROJECTED REVENUES UNDER DIFFERENT ECONOMIC ASSUMPTIONS

The alternative optimistic economic assumptions presented in Chapter II result in a higher path of current dollar GNP than do the baseline CBO economic assumptions. The alternative pessimistic assumptions result in a lower GNP path throughout the projection period. The optimistic GNP path is the net result of higher rates of real economic growth and lower rates of inflation than those in the baseline assumptions. The pessimistic GNP path is the net product of lower real growth rates and higher inflation.

The progressive individual income tax system generates less revenue per dollar of increase in the income tax base in high-growth, low-inflation times than in low-growth, high-inflation times. In the high-growth case, increases in income are more likely to arise from increased employment than from additional income accruing to those already working. Since new workers tend, on average, to face lower tax rates than do the workers receiving pay raises, the increase in income tax receipts per dollar of increase in personal income is slightly lower under the optimistic alternative than under the pessimistic alternative.

Revenue projections resulting from the optimistic economic assumptions exceed those in the CBO baseline projections by increasing amounts each year, reaching a differential of \$39 billion, or 4 percent, in 1987. These optimistic revenue projections include increases over the baseline projections in individual and corporate income taxes, social insurance taxes, and excise taxes. These revenue effects are partly offset by lower Federal Reserve System payments to the Treasury resulting from the lower level of interest rates. This offset is small, however, since these payments constitute only about 2 percent of total receipts.

Revenue projections under the pessimistic economic assumptions fall below those in the CBO baseline projections each year. As in the case of the optimistic revenue path, the differential between the pessimistic path and the baseline path widens each year--reaching \$30 billion, or 3 percent below the baseline path, by 1987. In the pessimistic case, the decrease in the revenues generated by the lower incomes is partly offset by increased Federal Reserve System payments, which reflect the higher interest rates, as well as by increased windfall profit taxes, which reflect the higher oil prices. In addition, the decrease in individual income taxes resulting from the reduced employment in the pessimistic path is offset to some extent by the increased inflation-induced movement of taxpayers into higher marginal tax brackets. The net result is a revenue path closer to the CBO baseline path than the optimistic path. The two alternative revenue projections are shown by major type of tax in Table 13.

The largest proportionate variation in taxes among the different economic projections occurs in corporate income taxes. This reflects the greater variance in corporate profits as compared with personal income under different economic conditions.

In both of the alternative sets of revenue projections, the effect of the different rates of inflation on individual income tax revenues is quite small during the 1982-1984 period. This diminished sensitivity to relative inflation rates is the product of the across-the-board rate reductions that are being phased in during the period.

The steady downward trend in the share of GNP claimed by taxes during the 1982-1987 period is maintained under both sets of alternative economic assumptions. Under the CBO baseline assumptions, the share falls from 20.6 percent in 1982 to 17.7 percent in 1987. Under the optimistic assumptions, it falls to 17.9 percent, and under the pessimistic assumptions, to 17.6 percent. The GNP shares for each set of economic assumptions are shown in Table 14.

#### REVISIONS IN PROJECTED REVENUES SINCE THE BUDGET RESOLUTION

As mentioned in Chapter II, the baseline revenue projections are considerably below the revenue targets established in the first and second budget resolutions for fiscal year 1982. In 1982, the difference between the two revenue projections is \$27 billion, or 4 percent of the resolution target revenue level. By 1984, the differential grows to \$74 billion, which constitutes a reduction of 10 percent from the budget resolution target.

TABLE 13. BASELINE REVENUE PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1982 Base	Projections				
		1983	1984	1985	1986	1987
Individual Income Taxes						
Optimistic alternative	300	304	317	350	378	413
CBO baseline projection	300	303	316	344	367	356
Pessimistic alternative	298	303	315	341	359	382
Corporate Income Taxes						
Optimistic alternative	50	55	71	77	82	90
CBO baseline projection	50	51	62	63	65	73
Pessimistic alternative	50	47	54	53	51	54
Social Insurance Taxes						
Optimistic alternative	209	229	254	288	320	350
CBO baseline projection	209	227	250	282	313	339
Pessimistic alternative	209	226	248	278	307	332
Excise Taxes						
Optimistic alternative	41	40	41	41	40	40
CBO baseline projection	41	40	40	40	40	40
Pessimistic alternative	42	41	43	43	43	43
Other Taxes						
Optimistic alternative	30	30	31	30	29	28
CBO baseline projection	31	31	33	34	34	34
Pessimistic alternative	31	32	35	38	39	40
Total						
Optimistic alternative	632	657	713	786	849	921
CBO baseline projection	631	652	701	763	818	882
Pessimistic alternative	630	649	695	752	799	852

TABLE 14. BASELINE REVENUE PROJECTIONS AS SHARES OF GNP UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year, in percents)

	1982 Base	Projections				
		1983	1984	1985	1986	1987
Optimistic Alternative	20.6	19.0	18.5	18.4	18.1	17.9
CBO Baseline Projection	20.6	19.0	18.5	18.3	18.0	17.7
Pessimistic Alternative	20.6	19.1	18.6	18.4	17.9	17.6

Almost all of the difference between the resolution target revenues and the baseline revenues is attributable to revisions in economic assumptions. The budget resolution's economic assumptions--formulated before the present recession developed--include 4 percent growth in real GNP in 1982, while the baseline assumptions show a drop of 0.1 percent. The improved inflation outlook since the resolution is reflected in the 7.5 percent inflation rate for 1982 in the baseline assumptions, which is well below the 8.6 percent rate in the budget resolution assumptions. As a result, the baseline GNP path remains about 6 percent below the budget resolution path during 1982, 1983, and 1984.

The lower employment resulting from the reduced economic activity and the decreased price level combine to reduce personal income in the baseline assumptions below that in the resolution assumptions. By 1984, taxable personal income in the baseline is almost \$150 billion below the resolution level.

Baseline corporate profits are projected to decrease by more than 10 percent in 1982, rather than increase (by more than 15 percent) as in the resolution assumptions. Baseline profits in 1982 are more than \$70 billion below those in the resolution. This difference narrows until, by 1984, the two profit assumptions are very similar.

These revisions in economic assumptions combine to reduce baseline revenues below those contained in the budget resolutions. The lower personal incomes are reflected in reduced individual income and social insurance taxes, and lower corporate profits are reflected in decreased corporate income taxes. In addition, a downward revision in oil price

assumptions is reflected in lower windfall profit taxes. A comparison of the two revenue projections is shown in Table 15.

**TABLE 15. COMPARISON OF BASELINE REVENUES AND FISCAL YEAR 1982 BUDGET RESOLUTION TARGETS (By fiscal year, in billions of dollars)**

	1982	1983	1984
CBO Baseline Revenues	631	652	701
1982 Budget Resolution Target	658	713	775
Difference	-27	-61	-74
Attributable to the difference between revenue reduction enacted and reduction recommended in the resolution	+12	+1	-3
Attributable to differences in economic assumptions	-37	-60	-73
Attributable to technical differences	-2	-3	-4



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## CHAPTER IV. BASELINE SPENDING PROJECTIONS

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The Congressional Budget Office estimates that 1982 budget outlays will equal \$740 billion. This figure represents 24.2 percent of the gross national product--a larger share of the GNP devoted to federal spending than in any year since World War II. Under the baseline assumptions, in which existing spending policies continue unchanged, federal outlays are projected to grow to \$1.1 trillion, but to decline to 22.7 percent of GNP by 1987. This rate of spending is still above the average for the postwar period.

As federal outlays grow, their composition among major spending categories will change. The share of the federal budget devoted to benefit payments is projected to remain roughly constant. National defense outlays, however, will grow somewhat more rapidly than other types of spending and will slightly increase their share of the budget. Net interest outlays will grow sharply, both in dollar terms and as a portion of the total budget. Other types of federal spending will grow at a below-average rate and will decline as a fraction of the budget.

Presented in this chapter are further details on the CBO baseline spending projections for fiscal years 1983-1987 and the sensitivity of those projections to economic assumptions. The chapter also compares the 1982-1984 baseline spending projections with the targets set in the First and Second Concurrent Resolutions on the Budget for Fiscal Year 1982.

### SPENDING PROJECTIONS FOR MAJOR PROGRAM CATEGORIES

Under the baseline assumptions, federal outlays will grow by \$390 billion, or 53 percent, between 1982 and 1987. The largest component of this projected increase is benefit payments for individuals, which is also the largest major category of spending (see Table 16). These payments--for retired and disabled workers and their dependents, unemployed workers, veterans, and low-income families and individuals--are projected to grow by \$182 billion, or 52 percent, during the next five years. Benefit payments have increased from 26 percent of federal outlays in 1960 to 32 percent in 1970 and 47 percent in 1982. Since they are projected to grow at about the same rate as total outlays over the next five years, their share of the federal budget is projected to remain at 47 percent, as depicted in Figure 6.

TABLE 16. BASELINE OUTLAY PROJECTIONS FOR MAJOR PROGRAM CATEGORIES  
(By fiscal year)

	1981 Actual <u>a/</u>	1982 Base	Projections				
			1983	1984	1985	1986	1987
In Billions of Dollars							
National Defense <u>b/</u>	160	190	214	238	263	286	303
Benefit Payments for Individuals <u>c/</u>	320	351	383	413	452	490	533
Grants to State and Local Governments <u>d/</u>	55	49	48	49	51	54	57
Net Interest	69	85	106	130	143	156	168
Other Federal Operations	<u>57</u>	<u>64</u>	<u>58</u>	<u>59</u>	<u>62</u>	<u>67</u>	<u>69</u>
Total Budget Outlays	661	740	809	889	971	1,052	1,130
Off-Budget Federal Entities	<u>21</u>	<u>20</u>	<u>19</u>	<u>18</u>	<u>18</u>	<u>20</u>	<u>22</u>
Total Outlays	682	760	828	907	989	1,072	1,152
-----							
As a Percent of GNP							
National Defense <u>b/</u>	5.6	6.2	6.2	6.3	6.3	6.3	6.1
Benefit Payments for Individuals <u>c/</u>	11.2	11.5	11.2	10.9	10.9	10.8	10.7
Grants to State and Local Governments <u>d/</u>	1.9	1.6	1.4	1.3	1.2	1.2	1.1
Net Interest	2.4	2.8	3.1	3.4	3.4	3.4	3.4
Other Federal Operations	<u>2.0</u>	<u>2.1</u>	<u>1.7</u>	<u>1.6</u>	<u>1.5</u>	<u>1.5</u>	<u>1.4</u>
Total Budget Outlays	23.1	24.2	23.6	23.5	23.3	23.1	22.7
Off-Budget Federal Entities	<u>0.7</u>	<u>0.7</u>	<u>0.6</u>	<u>0.5</u>	<u>0.4</u>	<u>0.4</u>	<u>0.4</u>
Total Outlays	23.8	24.9	24.2	24.0	23.7	23.5	23.1

a/ As reported in Department of the Treasury, Final Monthly Treasury Statement of Receipts and Outlays of the United States Government for Period from October 1, 1980 through September 30, 1981.

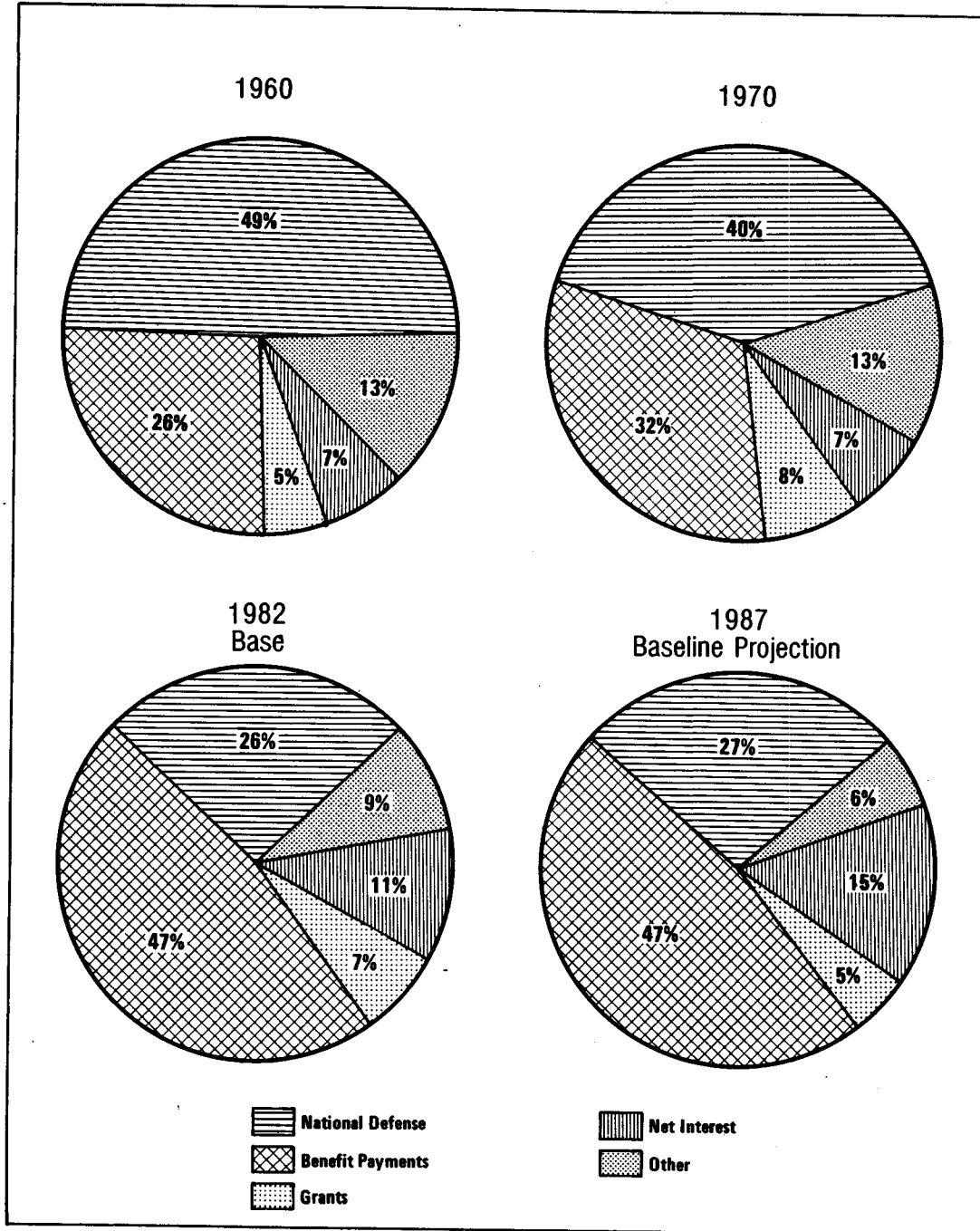
b/ Includes benefit payments for retired military personnel.

c/ Some grants to state and local governments are for benefit payments, such as Medicaid and public assistance (AFDC). These grants are classified here as benefit payments for individuals.

d/ This category covers grants for purposes such as general revenue sharing, highway construction, community development, and employment and training assistance. It does not include grants for benefit payments.



Figure 6.  
The Composition of Federal Spending



The next largest component is national defense programs, which are projected to grow by \$113 billion, or almost 60 percent, by 1987. The share of defense spending in the budget is projected to grow from 26 percent in 1982 to 27 percent by 1987, modestly reversing recent declines. In contrast, defense spending represented 49 percent of federal budget outlays in 1960 and 40 percent in 1970.

The most rapidly growing category of spending is net interest, which in 1960 and 1970 accounted for only 7 percent of the budget. Because of high interest rates and growing deficits, net interest outlays are projected to double from \$85 to \$168 billion over the next five years and to increase from 11 to 15 percent of the budget.

The remaining categories of federal spending--grants to state and local governments (other than for benefit payments) and other federal operations--grow only slightly, and their portion of the budget continues to shrink. Between 1970 and 1982, the combined share of these items fell from 21 to 16 percent of budget outlays. These categories of spending, which are projected to remain roughly constant in dollar terms between now and 1985, and to keep pace with inflation thereafter, will decline to 11 percent of total budget outlays by 1987.

### National Defense

National defense programs include not only the military activities of the Department of Defense but also the nuclear weapons programs of the Department of Energy and miscellaneous defense activities, such as defense stockpiles and selective service. The CBO defense baseline projections assume an explicit defense force structure and investment program, which is detailed in Appendix D. The outyear force structure reflects changes resulting from the introduction of new weapon systems and the deactivation of obsolete or worn-out systems. The CBO baseline methodology, in contrast to approaches that simply extrapolate spending levels, makes it possible to identify the outyear budget costs of specific defense weapon systems that are assumed to have been approved by the Congress. It is thus possible to calculate the budgetary effects of explicitly adding or deleting particular defense weapon systems when formulating a multiyear budget plan.

The defense baseline is first calculated in constant 1982 dollars and is then translated into current dollars using CBO economic assumptions. Both constant and current dollar defense baseline figures are shown in Table 17. Baseline outlays in current dollars grow from \$190 billion in 1982 to \$214 billion in 1983, \$238 billion in 1984, and \$303 billion in 1987--an

overall increase of almost 60 percent. This represents an average growth of 9.8 percent a year, which exceeds the projected rate of inflation by about 3 1/2 percentage points.

TABLE 17. DEFENSE SPENDING PROJECTIONS UNDER ALTERNATIVE PROGRAM ASSUMPTIONS (By fiscal year, in billions of dollars)

	1982 Base	Projections				
		1983	1984	1985	1986	1987
Defense Budget Authority						
CBO baseline projection						
Constant 1982 dollars	216	226	231	231	228	225
Current dollars	216	242	266	284	300	316
Alternative assumptions						
7 percent annual real growth	216	246	282	323	370	422
No real growth	216	232	249	267	285	305
Defense Outlays						
CBO baseline projection						
Constant 1982 dollars	190	204	216	224	228	227
Current dollars	190	214	238	263	286	303
Alternative assumptions						
7 percent annual real growth	190	215	245	283	327	373
No real growth	190	212	233	252	271	289

The growth in the baseline stems primarily from increases in the cost of procuring strategic weapons systems. Funding for the MX missile, Trident II missile, B-1 bomber, and KC-135 reengining grows significantly by 1987. To a lesser extent, the growth in baseline outlays also results from increases in the operating costs of strategic and tactical forces following delivery of weapons systems now or soon to be under construction.

Table 17 also compares the CBO defense baseline with two alternative defense spending paths. The first alternative is characterized by 7 percent annual real growth in defense appropriations, as assumed in the budget resolutions for 1982. The second alternative provides no real growth in budget authority for national defense programs. With 7 percent annual real growth, defense budget authority in 1987 would reach \$422 billion instead of the baseline figure of \$316 billion. Outlays in 1987 would rise to

\$373 billion instead of \$303 billion. With no real growth in appropriations, defense budget authority in 1987 would equal \$305 billion, and outlays would equal \$289 billion--\$14 billion less than the CBO baseline.

#### Benefit Payments for Individuals

Federal benefit payments for individuals total an estimated \$351 billion in 1982, which is 47 percent of total outlays. These programs provide both direct payments from the federal government to individuals (such as Social Security benefits) and indirect payments through state and local governments (such as Medicaid and public assistance). The major programs included in each category are shown in Table 18. Some programs, such as Social Security and unemployment compensation, provide cash payments to individuals to use at their discretion; other programs provide specific services used by eligible individuals (such as medical services under Medicare and Medicaid). The benefit payments category of spending also includes retirement pay for all federal civilian employees. Retirement benefits for military personnel are included under the national defense category.

Most benefit payments are directly or indirectly adjusted, or indexed, for inflation. Social Security benefits, for example, are adjusted automatically each year for increases in the cost of living as measured by the Consumer Price Index (CPI). Railroad retirement benefits, supplemental security income, veterans' pensions, and civil service retirement benefits similarly are adjusted each year for increases in the CPI. Benefits for certain other benefit payment programs, while not tied explicitly to the CPI, also increase directly as a result of inflation. These include the food stamp and child nutrition programs, which are indexed to various food price indexes. Black lung benefits for disabled coal miners are adjusted automatically each year by the amount of the October pay raises for federal civilian employees. The benefit levels for unemployment insurance are tied to earnings. Many states periodically increase Aid to Families with Dependent Children (AFDC) benefits for changes in the cost of living, although these changes have not kept pace with inflation in recent years. The baseline projections assume that similar adjustments will be made in the future. Finally, the cost of providing benefits in the Medicare and Medicaid programs increases with the rising cost of medical care services that are guaranteed to eligible beneficiaries.

Both direct and indirect benefit payments as a whole grow by about half over the 1982-1987 period. Because of projected increases in the number of beneficiaries and in real payment levels, this growth rate exceeds that in the Consumer Price Index, which grows by about one-third over the

TABLE 18. BASELINE OUTLAY PROJECTIONS FOR BENEFIT PAYMENTS FOR INDIVIDUALS (By fiscal year, in billions of dollars)

	1982 Base	Projections				
		1983	1984	1985	1986	1987
Direct Payments to Individuals						
Social Security (OASDI)	156	171	186	202	218	235
Medicare	50	58	68	78	90	103
Unemployment compensation	24	21	20	20	20	20
Supplemental security income	8	9	8	9	10	11
Federal employee retirement and disability <u>a/</u>	20	22	25	27	30	33
Food stamp program	11	12	12	13	14	15
Veterans' compensation, pensions, and readjustment benefits	15	15	16	16	17	18
Other	<u>25</u>	<u>29</u>	<u>29</u>	<u>32</u>	<u>32</u>	<u>34</u>
Subtotal	<u>309</u>	<u>338</u>	<u>364</u>	<u>397</u>	<u>431</u>	<u>468</u>
Indirect Payments through State and Local Governments						
Medicaid	18	20	22	25	28	30
Assistance payments program	8	8	8	9	9	10
Food and nutrition programs	5	5	6	6	7	7
Other	<u>11</u>	<u>12</u>	<u>13</u>	<u>15</u>	<u>15</u>	<u>17</u>
Subtotal	<u>42</u>	<u>45</u>	<u>49</u>	<u>55</u>	<u>59</u>	<u>64</u>
Total	351	383	413	452	490	533

a/ Excludes military retired pay, which is included in the national defense category.

same period. Direct benefit payments rise from \$309 billion in 1982 to \$468 billion in 1987, while indirect payments increase from \$42 billion to \$64 billion. The largest single category of benefits--Social Security--grows from \$156 billion to \$235 billion, also an increase of roughly 50 percent.

The most rapidly growing categories of benefits are Medicare and Medicaid, which are propelled upward by continued steep increases in health care costs. Over the next five years, Medicare outlays are projected to

more than double, while Medicaid payments to the states will increase by two-thirds. Unemployment compensation outlays, on the other hand, are projected to decline because of the assumed decrease in the unemployment rate.

### Grants to State and Local Governments

Grants to state and local governments (other than for benefit payments) make up about 7 percent of total budget outlays in 1982 (\$49 billion). Programs in this category include grants for the construction of wastewater treatment plants, grants for highway construction, community development grants, aid for elementary and secondary education, employment and training assistance, and general revenue sharing. These are detailed in Table 19.

TABLE 19. BASELINE OUTLAY PROJECTIONS FOR GRANTS TO STATE AND LOCAL GOVERNMENTS (By fiscal year, in billions of dollars)

	1982 Base	Projections				
		1983	1984	1985	1986	1987
EPA Construction Grants	4	4	4	3	3	3
Federal-aid Highways	8	8	9	9	10	10
Urban Mass Transportation	4	4	4	4	4	5
Community Development Grants	4	4	4	4	4	4
Elementary, Secondary, and Vocational Education	6	6	6	7	7	8
Employment and Training Assistance	3	3	3	4	4	4
Social Services	6	6	6	7	7	8
General Revenue Sharing	5	5	5	5	5	6
Other	<u>9</u>	<u>8</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>9</u>
Total	49	48	49	51	54	57